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PERSPECTIVE ON TRENDS IN THE SECURITIES INDUSTRY

(Address by Edward I. O'Brien Before the SIA Conference on Securities Industry Trends, January 23, 1980)

At the outset, I want to take this opportunity to welcome you to this important new undertaking, the first Conference on Securities Industry Trends.

As many of you realize, an event such as this does not just happen; it represents months of thought and dedicated effort of many in the industry and on the SIA staff. To each of them, to the speakers and panelists, I want to express my deepest appreciation.

I want to share with you a long-harbored dream. As a securities industry executive and as a lawyer I have felt that the financial and economic dimension of our industry is, coupled with sales and marketing, the industry's most important barometer and standard setter. For that reason, I have attempted to develop an economic and financial capacity at SIA to deal with the underlying capital, financial and economic ingredients of our business. Much has been accomplished to realize this goal over the last few years and this conference is in a way a reflection of the progress which has been made by the SIA in developing this

capacity, as well as a foreshadowing of what we intend to do in the future. The SIA Firm and Industry Analysis Committee has been a major force in bringing this dream to reality and my special thanks to them, and to Jon Bulkley its present Chairman, and to Alan Blanchard an earlier Chairman.

One matter of special concern I want to mention today involves the SEC. The chant is often heard that our industry needs an advocate in Washington to propagandize on its behalf and the SEC is usually selected as the organization to act as the securities industry sponsor. It certainly is true that the securities industry's vital role and major contribution to the capital raising function has often been misunderstood and undervalued and this deficiency must be corrected. However, to ask the SEC to take on the role of industry advocate may be at the same time legally impossible and too much to ask. What is appropriate, however, is to expect the SEC to understand the underlying economic forces which shape our industry, which motivate our sales programs and which bear on the legislative and regulatory initiatives which impact our industry in particular and the overall capital requirements of our nation and its investors. This capacity has been sorely lacking at the Commission until a few years ago and in the last year special efforts have been undertaken by the Commission to meet what I perceive to be its obligation in this regard. The SIA has relished the opportunity to express to the Commission the need to build its economic capacity and we have been encouraged by the initiative of the Commission in this area. The establishment of the Directorate of Economic

and Policy Research at the Commission and its support by the Chairman is a noteworthy event and we expect to see greater interest on the part of the Commission in at least three areas:

(a) Securities industry capital, its size, source, makeup and composition, as well as the need to change capital rules to keep up with the times.

(b) The economics of the industry, the makeup of its revenues, the expense picture, its profitability, all in so far as it relates to the public interest in being assured of a viable industry.

(c) The future direction of the industry, the new products and services to be developed, the relationship between the securities industry and others, such as banks, savings and loans, insurance companies.

All this economic interest has as its premise the need to know the economic facts in order to chart the direction of self-regulation, relations between complimentary or conflicting regulation and regulators, the so-called competition in regulation issue. Underlying this new economics intent of the SEC is the public requirement that competition is in the public interest and it should be fostered. At least this is the way the more enlightened elements of the industry see the emerging role of the SEC rather than saying that the Commission should be an industry partisan.

The securities industry changed more in the last ten years than many industries have changed in fifty. The days of gun-slinging portfolio managers and manual clearing seem as remote as the Model A Ford. Possibly more so. One good indicator of change is the level of output, a traditional yardstick of which is average daily volume on the NYSE. This went from average daily shares of 17.7 million in 1970 to 32 million shares in 1979. Two months ago, SEC Chairman Harold Williams spoke seriously of the imminence of 150 million share days.

A change even more striking than that in share volume is that share volume itself no longer reflects industry output as accurately as it once did. Securities firms, in their quest for greener pastures and less volatile earnings, have diversified into numerous activities, most of them within the financial area but some far outside of it. These are economic changes which will receive ample attention by other speakers today. I prefer to focus on the regulatory and political changes we have experienced in the past decade. There is a growing tendency to assume that all of the major regulatory changes originated in the 1975 Amendments, which is <u>not</u> the case.

The Stock Certificate

Before I consider further what has changed in ten years, I will discuss something which has not changed -- namely, the stock certificate. Ten years ago, many industry observers would have refused to believe that this item, which they considered a "barbarous relic," would be around in 1980. Barbarous relic or not, the stock certificate, like gold, is alive and well.

Ten years ago, this industry was knee deep in paper, and the stock certificate was a principal culprit. The unprecedented volume in the late 1960s short-circuited Wall Street's processing capacities, and faith in the securities markets and industry was fundamentally shaken. Underlying the difficulties were two main issues: broker/dealer financial responsibility and the need to streamline the clearing process. And at no other time in this industry's history were these two issues more nearly one.

Financial responsibility was, of course, the most urgent matter, and the actions taken were highly effective. More stringent net capital rules were established by the industry itself through the self-regulatory organizations. The NYSE disbursed millions of dollars out of its contingency fund and tapped its membership to safeguard customer accounts. Just as critical, was

the passage in 1970 of the Securities Investor Protection Act, which gave investors the kind of protection bank depositors in this country had enjoyed for decades. In a word, the industry itself protected its clients.

On the subject of streamlining the clearing process, here too the progress has been substantial. The NYSE and securities industry took the initiative in establishing depositories, and the Depository Trust Company today holds roughly $300 billion worth of securities.

Firms began to automate in earnest. The resoundingly successful launching of NASDAQ in 1971 was just one step among many in bringing technology to the markets. An important goal for the future is to further reduce paperwork and develop the locked-in trade as part of the emerging National Market System.

Commission Rates

An even more significant development on the regulatory front was, of course, the abolition of fixed commission rates. The 1975 Amendments made competitive rates the law of the land, but the SEC had already, in a process stretching over seven years, made the unfixing of rates a fait accompli.

— In December 1968, a new fixed rate schedule providing for volume discounts went into effect. This was the first concession to the growing power of institutional investors. It would not be the last.

— In April 1970, a surcharge on brokerage commissions was approved and later incorporated into the commission rate schedule. It is important to keep in mind that throughout the early 1970s, as the steps toward unfixing proceeded, the fixed rate schedule was being increased. The last such increase was granted by the SEC in November 1974.

— In April 1971, commissions on that part of a transaction exceeding $500,000 were made negotiable. Again, this move was made in recognition of the ongoing institutionalization of the marketplace.

— In April 1972, this limit was lowered to $300,000.

— In September 1973, the SEC granted an increase in commission rates but announced at the same time that all rate fixing by exchanges would end on May 1, 1975.

— In April 1974, commissions became negotiable on all transactions involving less than $2,000.

— Mayday 1975, when it came, had long been anticipated and, many felt, largely discounted. Its impact was softened initially by a dramatic market recovery and by the fact that more than two years would elapse before institutional discounts reached their present levels.

— The process was not completed until May 1, 1976, when floor brokerage commissions were made subject to negotiation. It is clear from this chronology of events that the unfixing of rates started well before the

Securities Acts Amendments of 1975. The challenge for the 1980s in the pricing area is to link profitability in pricing for securities services with value in the investment services for clients.

ERISA

The passage in 1974 of the Employee Retirement Income Security Act, commonly known as ERISA, affected the industry in several key ways:

— Prior to ERISA, many corporations had discharged their pension obligations on a strictly pay-as-you-go basis. The ERISA-mandated funding of pension plans increased the pool of capital that is professionally managed and has been a major factor in the increasing institutionalization of the securities markets. In the five years from mid-1974 to mid-1979, the assets of private non-insured pension funds went from $129 billion to $212 billion, representing a 64% increase.

— ERISA has complicated the relationship between broker/dealers and pension fund accounts, swelling the costs of compliance. Its prohibited transactions provisions restrict securities firms to serving a pension fund account in only one capacity -- either as broker, market maker, investment advisor, underwriter, etc., and not as more than one of these.

— But it is the fiduciary liability provisions of ERISA that may well prove to have had the strongest

impact upon both the securities industry and the overall economy. ERISA's prudent man rule has been given a very narrow interpretation, with predictable consequences for the capital allocation process. Risk aversion has been a salient feature of investment policy in the 1970s, and has contributed to the economic stagnation of the U.S. throughout the decade. The aversion to risk taking is a serious national preoccupation which must be overcome if our nation is to prosper and be able to compete internationally.

In 1978, only 58 corporations went public, as compared to 649 corporations in 1968. Conditions that have prevailed in the capital markets since 1972 have stifled smaller businesses and, through them, the entire economy. While these conditions are largely the result of inflation and its attendant phenomena, there is no denying that ERISA-type legislation has greatly raised the level of risk aversion among portfolio managers.

The 1975 Amendments

The 1975 Amendments grew out of the most extensive Congressional investigation of the securities markets since the Pecora hearings forty years earlier, and the changes they have wrought are comparable in scope.

The unfixing of commission rates was, as we have seen, already a fact by then. Other provisions of the '75 Amendments were to have consequences equally far-reaching if less immediate.

Section 11(a) of the Amendments mandated the separation once and for all of money management and brokerage. It was intended to eliminate the potential for account churning, and resolve the question of institutional membership on stock exchanges. The SEC has sought to reconcile the needs of different parties with the "effect versus execute" rule, whereby a broker/dealer can occupy the position of a commission-introducing broker with respect to agency business generated through institutional managed accounts.

The SEC was directed to remove impediments to a National Market System. A prerequisite for any National Market is equal regulation of all existing markets, something the Amendments achieved.

The interrelated goals of limit order protection and best execution are objectives of any National Market. While nothing like CLOB, the Central Limit Order Book, currently exists, the ITS now routinely channels orders in nearly 800 stocks to the market offering the best execution. And the Consolidated Tape has gone a long way toward uniting the different markets.

The future of regulations such as the NYSE's Rule 390, restricting member trading in listed securities to an exchange floor, remains unclear. But, as many observers predicted would happen, the importance of the third market greatly diminished since the unfixing of rates.

The most definite statement one can make concerning the National Market System is that no one knows for certain the form it will eventually take. Congress displayed great wisdom in granting the SEC broad discretionary powers concerning its implementation. And the SEC has likewise shown wise restraint in encouraging evolution with a demand for steady development. What needs to be emphasized is the industry's need for efficient markets with this efficiency finding its principal outlet in a sense of maximum interaction of orders to insure a fair price for buyers and sellers and reduced cost of execution of these orders.

The 1975 Amendments recognized that a national clearing system is comparable in importance to a national market system. This importance derives partly from a universal desire to avoid any recurrence of the paperwork problems of ten years ago and partly from the realization that technical compatibility of markets is as essential an ingredient of the National Market System as is equal regulation. In January 1977, the National Securities Clearing Corporation assumed the clearing operations of the NYSE, Amex and NASDAQ.

The relative ease with which our industry accommodated the record trading volume of the days following the Fed's credit tightening last October 6th shows how much progress has been made towards a national clearing system.

Removing Disincentives

I am optimistic by nature, as some of you may know, and it will not surprise you that I have saved the good news till the end. The good news for our industry -- and for industry in general -- comes from a most unexpected quarter: Washington, D. C. It involves more than just regulatory changes, however, being nothing less than an unmistakable change of heart towards business on the part of all branches of government. Faced with the erosion of our country's economic lead, government leaders, both elected and appointed, as well as the professional long-term government career person have been forced to re-appraise past policies. The most perceptive of them have realized that government, by enacting many anti-business measures over the past ten or fifteen years, has literally been biting the hand that feeds it. For, in taxation, as in many other things, less is more.

Ten years ago, government fiscal policy had not fundamentally changed since World War II. Fears of unemployment and recession remained uppermost in legislators' minds, and there was a consensus that the nation could stimulate itself out of any recession that came along. It was during this period that a conservative Republican president told a startled nation that, "We are all Keynesians now." As a matter of fact, many long-time Keynesians were beginning to have doubts.

The economic mainstream ten years ago downplayed the importance of the supply side of the economic equation,

focusing instead upon manipulation of demand and income redistribution. If capital formation somehow got lost in the shuffle, this posed no real problem. Any economy possessed of sufficient demand could presumably take care of itself. In the exhilarating climate of the late 1960s, the U.S. economy seemed capable of doing just that -- low unemployment, low taxes and soaring transfer payments -- but the price tag for all this was the inflation that ultimately came to haunt us.

The Revenue Act of 1969 raised to 35% the maximum capital gains tax rate. Combined with a slowing economy and mounting price increases, the tax hike was a real blow to hopes for continued economic growth. And much worse was to follow: the Revenue Act of 1976 raised the maximum effective tax rate on capital gains to slightly over 49%.

Faced with a swiftly declining currency and a government set on penalizing investment, Americans did what anyone would do: they turned to consumption. There was a time when people would shrug off extravagant consumer outlays with the remark: "It's good for the economy." But the truth is -- it <u>isn't</u> good for the economy. Americans consume a scandalously high proportion of their incomes.

The record shows that income which could be used to improve our productive capacity is being dissipated in consumption. It could be argued that this produces no

net loss of jobs, but the effects are only beginning to be felt. Our international competitive position has been weakened by the decline in investment and innovation. The U.S. is operating on an older industrial base than many other major industrialized economies, a situation that would have seemed incredible a generation ago. Industrial innovation -- by lowering costs per unit -- is a key weapon against inflation. The economy that fails to invest is committing itself to stagflation in the short run and obsolescence in the long run.

An elementary course in economics will define investment as foregone consumption. I can't resist the temptation to say that the opposite of delayed consumption is instant gratification, a poor lodestar, to be sure, in either business or government.

I ought not to speak too critically of those who choose to consume, however, when the government has provided so many disincentives to saving and investment. High capital gains and corporate income tax rates are prime examples.

I said I was saving the good news till the end, and I meant it. In November 1978, Congress provided the first reduction in capital gains tax rates in over forty years. At the same time, proposals to eliminate the double taxation of corporate dividends are receiving serious consideration from members of both political parties. This would have been unthinkable eight or ten

years ago. We began the decade with a conservative Republican president telling us we've all gone Keynesian, and we ended it with a liberal Democrat denouncing big government and extolling business initiative. The fact that he was brought to this conclusion reluctantly does not change the basic fact.

Such measures are, granted, only a start. But they are laying the groundwork for a period of noninflationary economic growth. The securities industry has historically been a major beneficiary of noninflationary economic growth.

One final note is my conviction that we must turn our creative energies to a new direction in our country in the immediate future. We owe it to our fellow citizens to tell them that it is in their interest and that of our nation and future generations to reemphasize the goals of saving and investing rather than continuing our spending ways of the last 20 years. We need this new direction to strengthen and enrich our national spirit, to provide for our security today and for the heritage that we owe those who come after us.